

HEARTLAND PAYMENT SYSTEMS INC

Form 10-Q

November 13, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 001-32594

HEARTLAND PAYMENT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

incorporation or organization)

90 Nassau Street, Princeton, New Jersey 08542

(Address of principal executive offices) (Zip Code)

22-3755714
(I.R.S. Employer

Identification Number)

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(609) 683-3831

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES NO

As of November 6, 2006, there were 37,151,492 shares of the registrant's Common Stock, \$.001 par value, outstanding.

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Table of Contents**Heartland Payment Systems, Inc. and Subsidiaries****Condensed Consolidated Balance Sheets***(In thousands, except share data)*

(unaudited)

	September 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 23,251	\$ 17,747
Receivables, net	98,265	93,756
Investments	2,522	2,141
Inventory	2,360	714
Prepaid expenses	1,427	1,979
Current tax asset	23,786	1,602
Current deferred tax assets, net	806	1,492
Total current assets	152,417	119,431
Capitalized customer acquisition costs, net	53,341	42,930
Deferred tax assets, net	4,059	3,477
Property and equipment, net	22,289	17,661
Goodwill and intangible assets	1,767	
Deposits and other assets	118	186
Total assets	\$ 233,991	\$ 183,685
Liabilities and stockholders equity		
Current liabilities:		
Due to sponsor bank	\$ 28,450	\$ 34,530
Accounts payable	28,127	25,339
Current portion of accrued buyout liability	11,186	10,478
Merchant deposits and loss reserves	4,514	7,450
Accrued expenses and other liabilities	9,614	7,407
Current portion of borrowings and financing arrangements	243	261
Total current liabilities	82,134	85,465
Long-term portion of borrowings and financing arrangements		173
Long-term portion of accrued buyout liability	21,051	17,996
Total liabilities	103,185	103,634
Commitments and contingencies (Note 11)		
Stockholders equity		
Common Stock, \$0.001 par value, 100,000,000 shares authorized; 38,193,179 and 34,222,114 shares issued at September 30, 2006 and December 31, 2005; 37,131,679 and 34,200,114 shares outstanding at September 30, 2006 and December 31, 2005	38	34
Additional paid-in capital	150,561	96,417
Accumulated other comprehensive loss	(19)	(26)
Retained earnings (Accumulated deficit)	5,165	(15,879)
Treasury stock, at cost (1,061,500 and 22,000 shares at September 30, 2006 and December 31, 2005)	(24,939)	(495)

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Total stockholders' equity	130,806	80,051
Total liabilities and stockholders' equity	\$ 233,991	\$ 183,685

See accompanying notes to condensed consolidated financial statements.

Table of Contents**Heartland Payment Systems, Inc. and Subsidiaries****Condensed Consolidated Statements of Income***(In thousands, except per share data)*

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Total Revenues	\$ 293,790	\$ 228,092	\$ 808,645	\$ 607,648
Costs of Services:				
Interchange	215,656	168,550	592,426	444,100
Dues and assessments	10,920	8,624	29,732	22,938
Processing and servicing	30,894	22,567	88,656	64,919
Customer acquisition costs	8,774	7,037	25,269	20,278
Depreciation and amortization	1,602	1,447	4,403	4,056
Total costs of services	267,846	208,225	740,486	556,291
General and administrative	11,699	10,169	35,489	28,448
Total expenses	279,545	218,394	775,975	584,739
Income from operations	14,245	9,698	32,670	22,909
Other income (expense):				
Interest income	431	239	1,261	422
Interest expense	(264)	(418)	(608)	(1,391)
Fair value adjustment for warrants with mandatory redemption provisions		(2,620)		(2,912)
Gain on settlement of financing arrangement		5,140		5,140
Other, net		4	831	11
Total other income (expense)	167	2,345	1,484	1,270
Income before income taxes	14,412	12,043	34,154	24,179
Provision for income taxes	4,273	5,507	12,182	10,568
Net income	10,139	6,536	21,972	13,611
Income allocated to Series A Senior Convertible Preferred Stock		1,326		4,728
Net income attributable to Common Stock	\$ 10,139	\$ 5,210	\$ 21,972	\$ 8,883
Net income	\$ 10,139	\$ 6,536	\$ 21,972	\$ 13,611
Other comprehensive income, net of tax: Unrealized gains (losses) on investments	9	(8)	7	(12)
Comprehensive income	\$ 10,148	\$ 6,528	\$ 21,979	\$ 13,599
Earnings per common share:				
Basic	\$ 0.27	\$ 0.21	\$ 0.61	\$ 0.46
Diluted	\$ 0.25	\$ 0.17	\$ 0.55	\$ 0.37

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Weighted average number of common shares outstanding:

Basic	36,939	24,995	36,096	19,331
Diluted	39,955	38,647	39,921	36,864

See accompanying notes to condensed consolidated financial statements.

Table of Contents**Heartland Payment Systems, Inc. and Subsidiaries****Condensed Consolidated Statement of Stockholders Equity***(In thousands)**(unaudited)*

	Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated		Treasury Stock	Total Stockholders Equity
	Shares	Amount	Shares	Amount		Other Comprehensive Loss	Retained Earnings (Accumulated Deficit)		
Nine Months Ended September 30, 2005:									
Balance, January 1, 2005	7,619	\$ 8	16,438	\$ 8	\$ 41,065	\$ (10)	\$ (34,972)		\$ 6,099
Issuance of Common Stock options exercised			1,446	1	6,429				6,430
Issuance of Common Stock on initial public offering			2,759	3	41,709				41,712
Accumulated other comprehensive loss						(12)			(12)
Conversion of preferred stock	(7,619)	(8)	13,333	13	(5)				
Two for one stock split				8	(8)				
Exercise of warrants			169		4,478				4,478
Net income for the period							13,611		13,611
Balance, September 30, 2005			34,145	\$ 33	\$ 93,668	\$ (22)	\$ (21,361)		\$ 72,318
Nine Months Ended September 30, 2006:									
Balance, January 1, 2006			34,200	\$ 34	\$ 96,417	\$ (26)	\$ (15,879)	\$ (495)	\$ 80,051
Issuance of Common Stock options exercised			3,971	4	25,719				25,723
Excess tax benefit on stock options exercised under SFAS No. 123R					27,661				27,661
Repurchase of Common Stock			(1,039)					(24,444)	(24,444)
Share-based compensation under SFAS No. 123R					764				764
Accumulated other comprehensive income						7			7
Dividends on common stock							(928)		(928)
Net income for the period							21,972		21,972
Balance, September 30, 2006			37,132	\$ 38	\$ 150,561	\$ (19)	\$ 5,165	\$ (24,939)	\$ 130,806

See accompanying notes to condensed consolidated financial statements.

Table of Contents**Heartland Payment Systems, Inc. and Subsidiaries****Condensed Consolidated Statements of Cash Flows***(In thousands)*

(unaudited)

	Nine Months Ended September 30,	
	2006	2005
Cash flows from operating activities		
Net income	\$ 21,972	\$ 13,611
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of capitalized customer acquisition costs	25,758	17,842
Other depreciation and amortization	5,537	4,062
Share-based compensation	764	
Deferred taxes	104	1,030
Gain on settlement of financing arrangement		(5,140)
Fair value adjustment for warrants with mandatory redemption provisions		2,912
Loss on disposal of property and equipment		33
Changes in operating assets and liabilities:		
Increase in receivables	(3,500)	(10,027)
Increase in inventory	(546)	(662)
Payment of signing bonuses, net	(23,934)	(14,723)
Increase in capitalized customer acquisition costs	(12,235)	(9,402)
Decrease (increase) in prepaid expenses	544	(123)
Decrease in deposits and other assets	5,474	1
Excess tax benefits on options exercised under SFAS No. 123R	(27,661)	
(Decrease) increase in due to sponsor bank	(6,081)	4,092
Increase (decrease) in accounts payable	1,913	(2,507)
Increase in accrued expenses and other liabilities	2,178	197
(Decrease) increase in merchant deposits and loss reserves	(2,936)	1,191
Payouts of accrued buyout liability	(7,983)	(11,420)
Increase in accrued buyout liability	11,746	11,838
Net cash (used in) provided by operating activities	(8,886)	2,805
Cash flows from investing activities		
Purchase of investments	(1,061)	(410)
Maturities of investments	687	166
Acquisition of business, net of cash acquired	(3,453)	
Proceeds from disposal of property and equipment		27
Purchases of property and equipment	(9,603)	(9,274)
Net cash used in investing activities	(13,430)	(9,491)
Cash flows from financing activities		
Principal payments on borrowings and financing arrangements	(192)	(7,459)
Proceeds from exercise of stock options	25,723	6,430
Proceeds from sale of common stock		41,712
Excess tax benefits on options exercised under SFAS No. 123R	27,661	
Repurchase of common stock	(24,444)	
Dividends paid on common stock	(928)	

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Net cash provided by financing activities	27,820	40,683
Net increase in cash and cash equivalents	5,504	33,997
Cash and cash equivalents at beginning of year	17,747	13,237
Cash and cash equivalents at end of period	\$ 23,251	\$ 47,234

Supplemental cash flow information:

Cash paid during the period for:		
Interest	\$ 611	\$ 1,339
Income taxes	6,604	11,312

Supplemental schedule of non-cash activities:

Amortization of other assets	\$ 71	\$ 112
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See accompanying notes to condensed consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

September 30, 2006

(unaudited)

1. Organization and Operations

Basis of Financial Statement Presentation The accompanying condensed consolidated financial statements include those of Heartland Payment Systems, Inc. (the Company) and its subsidiaries, Heartland Payroll Company (HPC) and Debittek, Inc. (Debittek). The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions with the Company's subsidiaries have been eliminated upon consolidation. The accompanying condensed consolidated financial statements are unaudited. In the opinion of the Company's management, the unaudited interim financial statements include all normal recurring adjustments necessary for a fair presentation of the Company's financial position at September 30, 2006, its results of operations for the three and nine months ended September 30, 2006 and 2005 and its cash flows for the nine months ended September 30, 2006 and 2005. Results of operations reported for interim periods are not necessarily indicative of the results to be expected for the year ended December 31, 2006. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements included in the Company's December 31, 2005 Annual Report on Form 10-K. The December 31, 2005 unaudited Condensed Consolidated Balance Sheet was derived from the audited 2005 Consolidated Financial Statements.

The officers and directors of the Company represent a majority of the outstanding shares, and so control the Company.

All outstanding common shares, average common shares, earnings per common share and conversion amounts related to stock options, warrants and Series A Senior Convertible Participating Preferred Stock have been adjusted retroactively to reflect a two-for-one stock split on July 26, 2005. On that date, the Company's Board of Directors and stockholders also increased the number of authorized shares of common stock to 100,000,000 and the number of shares authorized under the 2000 Equity Incentive Plan to 11,000,000.

Certain amounts for prior periods have been reclassified to conform with current presentation.

Business The Company provides payment-processing services related to bank card transactions for merchants throughout the United States. In addition, the Company provides certain other merchant services, including the sale and rental of terminal equipment and supplies. HPC provides payroll and related tax filing services throughout the United States. Debittek provides prepaid card and stored-value card solutions.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates include, among other things, the accrued buyout liability, capitalized customer acquisition costs, loss reserves, certain accounts payable and accrued expenses and certain tax assets and liabilities as well as the related valuation allowances, if any. Actual results could differ from those estimates. Interchange expense for the nine months ended September 30, 2006 included \$2.0 million recorded in the quarter ended March 31, 2006 for a change in estimate of the amount of on-line debit interchange expense the Company accrues. The change in estimate was based on new information which became available to the Company.

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

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(unaudited)

2. Summary of Significant Accounting Policies

Receivables The Company carries receivables from its merchants resulting from the practice of advancing interchange fees to most of its merchants during the month and collecting those fees from merchants at the beginning of the following month. During each month, the Company and its sponsor bank advance interchange fees to most of the Company's merchants. These advances to merchants are funded first with the Company's cash available for investment, then by incurring a payable to the Company's sponsor bank when that cash has been expended. The payable to the sponsor bank is repaid at the beginning of the following month out of the fees the Company collects from its merchants.

Capitalized Customer Acquisition Costs, net Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers (the Company's sales force) for the establishment of new merchant relationships, and (2) a deferred acquisition cost representing the estimated cost of buying out the commissions of vested sales employees. Pursuant to Staff Accounting Bulletin Topic 13, *Revenue Recognition*, and Financial Accounting Standards Board (FASB) Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The up-front signing bonus is based on the estimated gross margin for the first year of the merchant contract. The signing bonus, amount capitalized, and related amortization are adjusted after one year to reflect the actual gross margin generated by the merchant contract during that year. The deferred customer acquisition cost asset is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability, as described below.

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations. The Company believes that no impairment has occurred as of September 30, 2006 and December 31, 2005.

Merchant Deposits and Loss Reserves Disputes between a cardholder and a merchant periodically arise due to the cardholder's dissatisfaction with merchandise quality or the merchant's service, and the disputes may not always be resolved in the merchant's favor. In some of these cases, the transaction is charged back to the merchant and the purchase price is refunded to the cardholder by the credit card-issuing institution. If the merchant is unable to fund the refund, the Company is liable for the full amount of the transaction. The Company may have partial recourse to the Relationship Manager originally soliciting the merchant contract, if the Relationship Manager is still receiving income from the merchant's processing activities. Under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Other* (FIN 45), the Company's obligation to stand ready to perform is minimal. The Company maintains deposits or the pledge of a letter of credit from certain merchants as an offset to potential contingent liabilities that are the responsibility of such merchants. The Company evaluates its ultimate risk and records an estimate of potential loss for chargebacks related to merchant fraud based upon an assessment of actual historical fraud loss rates compared to recent processing volume levels. The Company believes that the liability recorded as loss reserves approximates fair value.

Accrued Buyout Liability Relationship Managers and sales managers are paid residual commissions based on the gross margin generated by monthly merchant processing activity. The Company has the right,

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Heartland Payment Systems, Inc. and Subsidiaries

Notes To Condensed Consolidated Financial Statements

September 30, 2006

(unaudited)

but is not obligated, to buy out some or all of these commissions, and intends to do so periodically. Such purchases of the commissions are at a fixed multiple of the last twelve months' commissions. Because of the Company's intent and ability to execute purchases of the residual commissions, and the mutual understanding between the Company and the Relationship Managers and sales managers, the Company has accounted for this deferred compensation arrangement pursuant to the substantive nature of the plan. The Company therefore records the amount that it would have to pay (the settlement cost) to buy out non-servicing related commissions in their entirety from vested Relationship Managers and sales managers, and an accrual, based on their progress towards vesting, for those unvested Relationship Managers and sales managers who are expected to vest in the future. As noted above, as the liability increases over the first year of a merchant contract, the Company also records for currently vested Relationship Managers and sales managers a related deferred acquisition cost asset. The accrued buyout liability associated with unvested Relationship Managers and sales managers is not included in the deferred acquisition cost asset since future services are required in order to vest. Subsequent changes in the settlement cost, due to account attrition, same-store sales growth and changes in gross margin, are included in the same income statement caption as customer acquisition cost amortization expense.

The accrued buyout liability is based on the merchants under contract at the balance sheet date, the gross margin generated by those merchants over the prior 12 months, and the contractual buyout multiple. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date. The same procedure is applied to unvested commissions over the expected vesting period, but is further adjusted to reflect the Company's experience that 31% of unvested Relationship Managers and sales managers become vested.

The classification of the accrued buyout liability between current and non-current liabilities on the consolidated balance sheet is based upon the Company's estimate of the amount of the accrued buyout liability that it reasonably expects to pay over the next twelve months. This estimate is developed by calculating the cumulative annual average percentage that total historical buyout payments represent of the accrued buyout liability. That percentage is applied to the period-end accrued buyout liability to determine the current portion.

Revenue Revenues are mainly comprised of gross processing revenue, payroll processing revenue and equipment-related income. Gross processing revenue primarily consists of discount fees and per-transaction and periodic (primarily monthly) fees from the processing of Visa and MasterCard bank card transactions for merchants. The Company passes through to its customers any changes in interchange or association fees. Gross processing revenue also includes American Express and Discover fees, customer service fees, fees for processing chargebacks, termination fees on terminated contracts, and other miscellaneous revenue. Payroll processing revenue includes periodic and annual fees charged by HPC for payroll processing services. Revenue is recorded as bank card transactions are processed or payroll services are performed. Equipment-related income includes revenues from the sale, rental and deployment of bank card terminals, and from the sale of hardware, software and associated services for prepaid card and stored-value card payment systems. Revenues are recorded at the time of shipment, or the provision of service.

Income Taxes The Company accounts for income taxes by recognizing deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statements and the tax basis of assets and liabilities using enacted tax rates.

Stock Options The Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R) on January 1, 2006. This statement revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and its related implementation guidance. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under the fair value method. Pursuant to SFAS No. 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the

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requisite service period. The Company elected to adopt the modified-prospective-transition method, as provided by SFAS No. 123R. Accordingly, prior period amounts have not been restated. Under this transitional method, the Company is required to record compensation expense for all awards granted after the date of adoption using the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R and for the unvested portion of previously granted awards using the grant-date fair value estimated in accordance with the provisions of SFAS No. 123.

Additionally, SFAS No. 123R amends SFAS No. 95, *Statement of Cash Flows* (SFAS No. 95), to require the excess tax benefits to be reported as a financing cash inflow rather than a reduction of taxes paid, which is included within operating cash flows. Accordingly, cash provided by operating activities decreased and cash provided by financing activities increased by \$27.7 million related to excess tax benefits from share-based awards. The excess tax benefits result from employees exercising non-qualified stock options and making disqualifying dispositions of shares acquired through their exercise of incentive stock options.

The application of SFAS No. 123R had the following effects on reported amounts relative to amounts that the Company would have reported using the intrinsic value method under APB No. 25 for the three and nine month periods ended September 30, 2006 (in thousands, except per share data):

	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
	After Effect of		After Effect of	
	Following APB No.	Adopting SFAS No.	Following APB No.	Adopting SFAS No.
	25	123R	25	123R
Income from operations	\$ 14,548	\$ 14,245	\$ 33,434	\$ 32,670
Income before income taxes	14,715	14,412	34,918	34,154
Net income	10,368	10,139	22,585	21,972
Earnings per common share:				
Basic	\$ 0.28	\$ 0.27	\$ 0.63	\$ 0.61
Diluted	\$ 0.26	\$ 0.25	\$ 0.57	\$ 0.55
Net cash provided by (used in) operating activities	\$ 1,978	\$ 3,369	\$ 10,725	\$ (8,886)
Net cash provided by financing activities	3,691	2,300	8,209	27,820

Prior to the adoption of SFAS No. 123R, the Company accounted for its stock options using the intrinsic value method in which no compensation expense has been recognized for its share-based compensation plans because the options were granted at an exercise price greater than or equal to the estimated fair value at the grant date. The following table presents the effects on net income and basic and diluted net income per common share had the Company adopted the fair value method of accounting for share-based compensation under SFAS No. 123 for the three and nine months ended September 30, 2005 (in thousands, except per share data):

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	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income	\$ 6,536	\$ 13,611
Deduct: Total share-based employee compensation expense determined under fair value-based method, net of related tax expense	1,848	3,767
Pro forma net income	4,688	9,844
Less: Income allocated to Series A Senior Convertible Participating Preferred Stock	951	3,430
Pro forma net income attributable to common stock	\$ 3,737	\$ 6,414
Earnings per share:		
As reported:		
Basic	\$ 0.21	\$ 0.46
Diluted	\$ 0.17	\$ 0.37
Pro forma:		
Basic	\$ 0.15	\$ 0.33
Diluted	\$ 0.12	\$ 0.27

Basic earnings per share for the three and nine months ended September 30, 2005 was computed and presented under the two-class method and was based on the weighted average number of common shares outstanding and assumes an allocation of net income to the Series A Senior Convertible Participating Preferred Stock (the Convertible Preferred) for the period or portion of the period that the Convertible Preferred was outstanding. The Convertible Preferred automatically converted into 13,333,334 shares of the Company's common stock upon the August 16, 2005 closing of the Company's initial public offering.

Diluted earnings per share for the three and nine months ended September 30, 2005 was computed based on the weighted average outstanding common shares plus equivalent shares assuming exercise of stock options, warrants and conversion of Series A Senior Convertible Participating Preferred Stock, where dilutive. Weighted average shares outstanding and dilutive securities for the nine months ended September 30, 2005 have been adjusted to reflect a two-for-one stock split on July 26, 2005.

Recent Accounting Pronouncements The FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN No. 48), in June 2006. FIN No. 48 clarifies the accounting for the recognition and measurement of tax benefits associated with uncertain tax positions and defines criterion that an individual tax position must meet for any part of that position to be recognized or continue to be recognized in the financial statements. FIN No. 48 also adds disclosure requirements for the amounts of unrecognized tax benefits associated with uncertain tax positions. An uncertain tax position exists if it is unclear how a transaction will be treated under tax law. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company does not believe that the application of FIN No. 48 will have a material effect on its consolidated financial position, results of operations or cash flows.

The FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), in September 2006. SFAS No. 157 establishes a single authoritative definition of fair value in generally accepted accounting principles (GAAP), sets out a framework for measuring fair value, and requires additional disclosures about fair value measurements. SFAS No. 157 applies only to fair value measurements that are already required or permitted by other accounting standards and is expected to increase the consistency of those measurements. The Company does not believe that the application of SFAS No. 157 will have a material effect on its consolidated financial position, results of operations or cash flows.

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Heartland Payment Systems, Inc. and Subsidiaries
Notes To Condensed Consolidated Financial Statements

September 30, 2006

(unaudited)

3. Acquisition

Effective January 1, 2006, the Company acquired the stock of Debittek, Inc. (Debittek) from Ingenico Inc. for a gross cash payment of approximately \$5.2 million. The Company acquired Debittek, Inc. to obtain a proven platform and solutions provider in the prepaid and stored-value cards market, particularly with respect to small-dollar payment applications. This acquisition is not expected to have a material impact on earnings in the near term. Pro forma results of operations have not been presented because the effect of the acquisition was not material. The transaction was accounted for under the purchase method of accounting.

The total purchase price was allocated as follows: \$1.7 million to goodwill, \$121,000 to intangible assets and \$3.4 million to net tangible assets, including cash of \$1.7 million.

4. Receivables

A summary of receivables by major class is as follows at September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005
	(In thousands)	
Accounts receivable from merchants	\$ 94,316	\$ 91,288
Accounts receivable from others	4,123	2,536
	98,439	93,824
Less allowance for doubtful accounts	(174)	(68)
Total receivables, net	\$ 98,265	\$ 93,756

Included in accounts receivable from others are \$1,833,000 and \$1,519,000 which are due from employees at September 30, 2006 and December 31, 2005, respectively.

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5. Capitalized Customer Acquisition Costs, Net

A summary of the capitalized customer acquisition costs, net, is as follows as of September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005
	(In thousands)	
Capitalized signing bonuses	\$ 69,852	\$ 54,388
Less accumulated amortization	(30,370)	(22,727)
	39,482	31,661
Capitalized customer deferred acquisition costs	38,408	26,172
Less accumulated amortization	(24,549)	(14,903)
	13,859	11,269
Capitalized Customer Acquisition Costs, Net	\$ 53,341	\$ 42,930

A summary of the activity in capitalized customer acquisition costs, net for the three and nine month periods ended September 30, 2006 and 2005 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)			
Balance at beginning of period	\$ 50,473	\$ 38,419	\$ 42,930	\$ 34,247
Plus additions to:				
Capitalized signing bonuses, net	7,979	4,981	23,934	14,723
Capitalized customer deferred acquisition costs	3,843	3,446	12,235	9,402
	11,822	8,427	36,169	24,125
Less amortization expense on:				
Capitalized signing bonuses, net	(5,705)	(3,575)	(16,113)	(10,273)
Capitalized customer deferred acquisition costs	(3,249)	(2,741)	(9,645)	(7,569)
	(8,954)	(6,316)	(25,758)	(17,842)
Balance at end of period	\$ 53,341	\$ 40,530	\$ 53,341	\$ 40,530

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Net signing bonus adjustments from estimated amounts to actual were \$(0.2) million and \$(1.3) million, respectively, for the three months ended September 30, 2006 and 2005, and \$0.8 million and \$(2.7) million, respectively, for the nine months ended September 30, 2006 and 2005. Net signing bonus adjustments are netted against additions in the table above.

Fully amortized signing bonuses of \$3.9 million and \$1.3 million, respectively, were written off during the three month periods ended September 30, 2006 and 2005, and \$9.5 million and \$5.8 million, respectively, were written off during the nine months ended September 30, 2006 and 2005.

The Company believes that no impairment has occurred as of September 30, 2006 and December 31, 2005.

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6. Merchant Deposits and Loss Reserves

The Company's merchants have the liability for any charges properly reversed by the cardholder through a mechanism known as a chargeback. If the merchant is unable to pay this amount, the Company will be liable to the Visa and MasterCard associations for the reversed charges. Under FIN 45, the Company determined that the fair value of its obligation to stand ready to perform is minimal. The Company requires personal guarantees, merchant deposits and letters of credit from certain merchants to minimize its obligation. As of September 30, 2006 and December 31, 2005, the Company held merchant deposits totaling \$4.0 million and \$7.0 million, and letters of credit totaling \$380,000 and \$519,000, respectively.

The Visa and MasterCard associations generally allow chargebacks up to four months after the later of the date the transaction is processed or the delivery of the product or service to the cardholder. As the majority of the Company's transactions involve the delivery of the product or service at the time of the transaction, a reasonable basis for determining an estimate of the Company's exposure to chargebacks is the last four months' processing volume on its portfolio, which was \$15.5 billion and \$12.0 billion for the four months ended September 30, 2006 and December 31, 2005, respectively. However, for the four months ended September 30, 2006 and December 31, 2005, the Company was presented with \$9.9 million and \$6.6 million, respectively, in chargebacks by issuing banks. In the nine months ended September 30, 2006 and the year ended December 31, 2005, the Company incurred merchant credit losses of \$1.0 million and \$1.2 million, respectively, on total dollar volume processed of \$31.9 billion and \$33.7 billion, respectively. These credit losses are included in processing and servicing costs in the Company's consolidated statements of operations.

The loss recorded by the Company for chargebacks associated with any individual merchant is typically small, due both to the relatively small size and the processing profile of the Company's clients. However, from time to time the Company will encounter instances of merchant fraud, and the resulting chargeback losses may be considerably more significant to the Company. The Company has established a contingent reserve for estimated currently existing credit and fraud losses on its consolidated balance sheets, amounting to \$480,000 on September 30, 2006 and \$485,000 December 31, 2005. This reserve is determined by performing an analysis of the Company's historical loss experience applied to current processing volume and exposures.

A summary of the activity in the loss reserve for the three and nine month periods ended September 30, 2006 and 2005 was as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
	(In thousands)			
Beginning balance	\$ 486	\$ 475	\$ 485	\$ 468
Additions to reserve	363	211	1,068	835
Charges against reserve	(369)	(205)	(1,073)	(822)
Ending balance	\$ 480	\$ 481	\$ 480	\$ 481

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7. Accrued Buyout Liability

A summary of the accrued buyout liability is as follows as of September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005
(In thousands)		
Vested Relationship Managers and sales managers	\$ 31,028	\$ 27,228
Unvested Relationship Managers and sales managers	1,209	1,246
	32,237	28,474
Less current portion	(11,186)	(10,478)
Long-term portion of accrued buyout liability	\$ 21,051	\$ 17,996

In calculating the accrued buyout liability for unvested Relationship Managers and sales managers, the Company has assumed that 31% of the unvested Relationship Managers and sales managers will vest in the future, which represents the Company's historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested Relationship Managers and sales managers by \$0.2 million at both September 30, 2006 and December 31, 2005.

A summary of the activity in the accrued buyout liability for the three and nine month periods ended September 30, 2006 and 2005 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
(In thousands)				
Beginning balance	\$ 30,413	\$ 29,725	\$ 28,474	\$ 27,035
Increase in settlement obligation, net	3,663	4,167	11,746	11,838
Buyouts	(1,839)	(6,439)	(7,983)	(11,420)
Ending balance	\$ 32,237	\$ 27,453	\$ 32,237	\$ 27,453

The increase in settlement obligation is due to new merchant account signings, as well as same-store sales growth and changes in gross margin, partially offset by the impact of merchant attrition.

8. Stockholders' Equity

Common Stock Repurchases. On January 13, 2006, the Company's Board of Directors authorized management to repurchase up to the lesser of (a) 1,000,000 shares of the Company's common stock or (b) \$25,000,000 worth of its common stock in the open market.

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On August 1, 2006, the Company's board of directors authorized management to repurchase up to 1,000,000 shares of its common stock in the open market using the proceeds from the exercise of stock options. This authorization is in addition to the 1,000,000 common shares which the board of directors had authorized on January 13, 2006.

Under these authorizations, the Company had repurchased 1,039,500 shares of its common stock during the nine months ended September 30, 2006 at a cost of \$24.4 million. Management intends to use these authorizations to repurchase shares opportunistically as a means of offsetting dilution from shares issued upon the exercise of options under employee benefit plans. Management has no obligation to repurchase shares under the authorization, and the specific timing and amount of the stock repurchase will vary based on market conditions, securities law limitations and other factors. The stock repurchase will be executed utilizing the Company's cash resources including the proceeds of stock options exercises.

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Dividends on Common Stock. On August 1, 2006, the Company's board of directors declared a quarterly cash dividend of \$0.025 per share of common stock, which was paid on September 15, 2006 to stockholders of record as of August 25, 2006.

On November 2, 2006, the Company's board of directors declared a quarterly cash dividend of \$0.025 per share of common stock, payable on December 15, 2006 to stockholders of record as of November 24, 2006.

Initial Public Offering. On August 10, 2005, the Company's Registration Statement on Form S-1 (Registration No. 333-118073), which registered shares of the Company's common stock, \$0.001 par value, under the Securities Act of 1933, as amended, was declared effective by the Securities and Exchange Commission. The offering consisted of 7,762,500 shares of the Company's common stock, 2,758,546 of which were sold by the Company and 5,003,954 of which were sold by certain selling stockholders at a price to the public of \$18.00 per share. Upon the closing of the offering on August 16, 2005, all outstanding shares of the Company's Series A Senior Convertible Participating Preferred Stock were automatically converted into 13,333,334 shares of common stock.

Series A Senior Convertible Participating Preferred Stock. The Company's previously outstanding Series A Senior Convertible Participating Preferred Stock (the "Convertible Preferred") automatically converted into 13,333,334 shares of the Company's Common Stock upon the August 16, 2005 closing of the Company's initial public offering. Prior to that automatic conversion, the Convertible Preferred was convertible by the holders at any time, participated equally in dividends and distributions with the Common Stock, paid no other dividends and had a liquidation preference of \$80 million.

Warrants. In connection with a bridge loan, which was repaid in 2001, the Company issued 337,810 five-year mandatory redeemable warrants to purchase its Common Stock for \$0.005, which were initially valued at \$605,049. Commencing July 26, 2003, the holder could require the Company to redeem these warrants at their per share fair value. The Company had recorded these warrants as debt at their estimated fair value.

On January 8, 2004, the warrant holder elected to cause the Company to redeem 168,906 shares at the fair value of \$6.25 per share. On August 16, 2005, the closing date for the Company's initial public offering, the Company exercised its right to require the warrant holder to exercise its remaining warrants for 168,904 shares at the exercise price of \$0.005 per share.

The Company adjusted the carrying value of the warrants by \$2.6 million during the three months ended September 30, 2005 through a charge to the income statement to reflect the estimated fair value of \$26.51 per share as of August 16, 2005. For the nine months ended September 30, 2005, the Company adjusted the carrying value of the warrants by \$2.9 million. Upon the exercise of the remaining warrants on August 16, 2005, their full carrying value of \$4.5 million was transferred to stockholders' equity.

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9. Income Taxes

The provision for income taxes for the three and nine month periods ended September 30, 2006 and 2005 consists of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)			
Current				
Federal	\$ 5,960	\$ 3,119	\$ 12,644	\$ 7,753
State	(1,904)	720	(505)	1,785
Deferred				
Federal	(345)	1,354	(489)	836
State	562	314	532	194
Total provision for income taxes	\$ 4,273	\$ 5,507	\$ 12,182	\$ 10,568

The differences in federal income taxes provided and the amounts determined by applying the federal statutory tax rate of 35% to income before income taxes for the nine months ended September 30, 2006 and 2005 were:

	Nine Months Ended September 30, 2006		Nine Months Ended September 30, 2005	
	%	Amount (In thousands)	%	Amount (In thousands)
U.S. federal income tax at statutory rate	35.00%	\$ 11,954	35.00%	\$ 8,463
U.S. state and local income taxes, net	1.57%	535	5.32%	1,286
Warrants			3.04%	735
Nondeductible expenses	0.62%	211	0.15%	37
Prior year book to tax true up	(1.52)%	(518)		
Other, net			0.19%	47
Provision for income taxes	35.67%	\$ 12,182	43.70%	\$ 10,568

In connection with preparing its 2005 state income tax returns during the third quarter of 2006, the Company analyzed the approaches it applied for sourcing taxable income to individual states and determined that its prior approaches did not accurately reflect the income sourcing regulations of certain of those states. The Company revised those state income sourcing approaches in the third quarter of 2006, and as a result realized reductions of its 2005 state income tax expense and its 2006 estimated effective annual state tax rates. In accordance with APB 28, *Interim Financial Reporting*, the Company recorded the resulting total state tax benefit of \$1.5 million in the third quarter of 2006, of which \$0.5 million related to 2005 and \$1.0 million related to the nine months ended September 30, 2006, including \$0.4 million for the third quarter of 2006. Including the \$1.5 million of state tax benefits, the Company's overall estimated effective annual tax rates for the three months ended September 30, 2006 and the nine months ended September 30, 2006 were 29.6% and 35.7%, respectively. For the 2006 fourth quarter and full year, the Company expects its overall estimated effective annual tax rates to be approximately 37.2% and 36.2%, respectively.

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During the nine months ended September 30, 2006, the Company recorded current tax assets of \$27.7 million reflecting excess tax benefits resulting from employees exercising non-qualified stock options and making disqualifying dispositions of shares acquired through their exercise of incentive stock options. The Company realized \$8.1 million of that current tax asset as reductions of estimated income tax payments during the nine months ended September 30, 2006. The Company expects to realize the remaining current tax asset as a reduction of future period estimated tax payments and by recovering the estimated tax payments it made during the nine months ended September 30, 2006. For the nine months

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ended September 30, 2006, the Company classified the \$27.7 million of excess tax benefits as a cash inflow from financing activities and a cash outflow from operating activities in its Consolidated Condensed Statement of Cash Flows in accordance with SFAS No. 123R and SFAS No. 95, as amended.

The net deferred tax asset was comprised of the following at September 30, 2006 and December 31, 2005:

	September 30, 2006	December 31, 2005
	(In thousands)	
Deferred tax assets:		
Merchant contract costs	\$ 21,167	\$ 21,488
Borrowings and financing arrangement	91	185
Loss reserve and accounts receivable allowance	244	235
SFAS No. 123R share based compensation	138	
Property & equipment	35	
Other	16	25
Deferred tax asset	21,691	21,933
Deferred tax liabilities:		
Capitalized signing bonus	14,754	13,456
Deferred state tax liability	110	327
Software development	1,962	1,749
Property and equipment		1,432
Deferred tax liability	16,826	16,964
Net deferred tax asset	4,865	4,969
Less current portion	(806)	(1,492)
Net deferred tax asset non current portion	\$ 4,059	\$ 3,477

At September 30, 2006 and December 31, 2005, the Company has determined that no valuation allowance against the net deferred tax asset was required. The Company has no federal or state net operating loss carryforwards.

10. Stock Incentive Plans

At September 30, 2006, the Company had two share-based plans for employees, which are described below. The Company adopted SFAS No. 123R on January 1, 2006 and began recognizing compensation expense in its income statement for its share-based plans. Prior to the adoption of SFAS No. 123R, the Company accounted for its stock options using the intrinsic value method under APB No. 25 in which no compensation expense has been recognized for its share-based compensation plans. Amounts the Company recognized in its financial statements for the three and nine months ended September 30, 2006 and 2005 with respect to these share-based plans were as follows:

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	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Compensation expense recognized on share-based plans before income tax benefit	\$ 303	\$	\$ 764	\$
Related income tax benefit recognized in the income statement	74		151	
Cash received from stock option exercises	5,119	6,322	25,723	6,430
Excess tax benefit recorded for tax deductions resulting from the exercise of stock options	2,547		27,661	
Tax benefit realized as reductions of estimated tax payments during the period	3,850		8,050	

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The Company estimates the grant date fair value of the stock options it issues using a Black-Scholes valuation model. The Company determines an expected volatility assumption by referencing the average volatility assumed by six of its public company peers. The Company used an average of a peer group because it does not have sufficient historical volatility data related to market trading of its own common stock. The weighted-average fair value of options granted during the nine months ended September 30, 2006 and the years ended December 31, 2005 and 2004 were \$10.81, \$5.48 and \$2.74, respectively. The fair value of options granted for the nine months ended September 30, 2006 and the years ended December 31, 2005 and 2004 was estimated at the grant date using the following weighted average assumptions:

	Nine Months Ended	Years Ended December 31,	
	September 30, 2006	2005	2004
Expected volatility	50%	50%	50%
Expected life	3.75 years	3 years	1 to 3 years
Dividends	0.40%	0.00%	0.00%
Risk-free interest rate	4.88%	3.73%	2.31%

At September 30, 2006, there was a total of \$1.6 million of unrecognized compensation expense related to unvested stock options. This expense is expected to be recognized over a weighted average period of 2.0 years.

Amended and Restated 2000 Equity Incentive Plan. The maximum number of share awards which may be granted during the term of the Heartland Payment Systems, Inc. Amended and Restated 2000 Equity Incentive Plan (the "2000 Equity Incentive Plan") is 11,000,000, of which 107,770 stock options were granted during the nine months ended September 30, 2006 and 1,324,437, 3,167,594 and 2,583,458 stock options were granted during 2005, 2004 and 2003, respectively. The majority of the options granted in 2005, 2004 and 2003 vested immediately; however, 662,370 options as of September 30, 2006, including the options granted in 2006, are unvested and will vest over a period of one to four years. At September 30, 2006, there were 4,321,082 options outstanding under the 2000 Equity Incentive Plan, and 1,610,991 shares of the 11,000,000 authorized shares of common stock reserved for issuance under the 2000 Equity Incentive Plan remain available for grant. The options were granted with terms of 5 to 10 years and an exercise price equal to or in excess of the estimated fair value of the Company's common stock at the date of the grant.

2002 PEPSHares Plan. The Company also has 73,571 options outstanding under its 2002 PEPSHares Plan, as amended (the "PEPSHares Plan"). The options were granted with an exercise price equal to or in excess of the estimated fair value of the Company's common stock at the date of the grant. The Administrator of the PEPSHares Plan determined that no further grants would be made under the PEPSHares Plan after December 31, 2004.

Share-Based Plan Activity. During the nine months ended September 30, 2006, employees exercised 3,969,065 options to acquire the Company's common stock, generating \$25.7 million of stockholders' equity from the exercises and \$27.7 million of stockholders' equity related to tax deductions, which accrued to the Company as employees exercised non-qualified stock options and made disqualifying dispositions of shares acquired through the exercise of incentive stock options. Activity in the 2000 Equity Incentive Plan and PEPSHares Plan during the 2005 full year and the nine months ended September 30, 2006 was as follows:

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	2000 Equity Incentive Plan		2002 PEPShares Plan	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at January 1, 2005	7,132,094	\$ 6.23	1,538,130	\$ 5.89
Issued	1,324,437	\$ 14.61		\$
Exercised	(199,771)	\$ 5.54	(1,308,832)	\$ 5.87
Forfeited/cancelled	(137,831)	\$ 6.75	(65,402)	\$ 9.52
Outstanding at December 31, 2005	8,118,929	\$ 7.60	163,896	\$ 5.59
Options exercisable at December 31, 2005	7,346,704	\$ 7.40	163,896	\$ 5.59
Issued	107,770	\$ 25.65		\$
Exercised	(3,881,740)	\$ 6.52	(87,325)	\$ 5.53
Forfeited/cancelled	(23,877)	\$ 13.32	(3,000)	\$ 5.00
Outstanding at September 30, 2006	4,321,082	\$ 8.98	73,571	\$ 5.69
Options exercisable at September 30, 2006	3,629,087	\$ 8.39	73,571	\$ 5.69

Outstanding options and exercisable options at September 30, 2006 are summarized by exercise price below:

Exercise price per share	Outstanding Options			Exercisable Options		
	2000 Equity Incentive Plan	2002 PEPShares Plan	Total	2000 Equity Incentive Plan	2002 PEPShares Plan	Total
\$3.00	243,560		243,560	243,560		243,560
\$5.00	1,135,889	32,750	1,168,639	1,135,889	32,750	1,168,639
\$6.25 to \$7.50	969,533	40,821	1,010,354	763,783	40,821	804,604
\$9.28	888,981		888,981	708,981		708,981
\$9.80 to \$11.00	590,724		590,724	440,224		440,224
\$21.55 to \$21.60	150,868		150,868	138,493		138,493
\$24.22 to \$26.66	341,527		341,527	198,157		198,157
	4,321,082	73,571	4,394,653	3,629,087	73,571	3,702,658

11. Commitments and Contingencies

Litigation The Company is involved in certain legal proceedings and claims, which arise in the ordinary course of business. In the opinion of the Company, the results of any of these matters, individually and in the aggregate, are not expected to have a material effect on its results of operations, financial condition or cash flows.

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Leases The Company leases various office space and certain equipment under operating leases with remaining terms ranging up to eight years. The majority of the lease agreements for office space contain renewal options and generally require the Company to pay certain operating expenses.

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Future minimum lease commitments under noncancelable leases as of September 30, 2006 are as follows:

Twelve Months Ended		
September 30,		(In thousands)
	2007	\$ 2,042
	2008	1,441
	2009	788
	2010	628
	2011	640
	Thereafter	801
		\$ 6,340

Rent expense for leased property was \$515,000 and \$374,000, respectively, for the three months ended September 30, 2006 and 2005 and \$1.6 million and \$970,000, respectively, for the nine months ended September 30, 2006 and 2005.

Contingencies The Company collects and stores sensitive data about its merchant customers and bank cardholders. If the Company's network security is breached or sensitive merchant or cardholder data is misappropriated, the Company could be exposed to assessments, fines or litigation costs.

12. Related Party Transactions

In July 2003, Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund granted the Company's Chief Executive Officer an irrevocable option to purchase up to an aggregate of 1,750,000 shares of the Company's Common Stock at any time on or before July 31, 2006 at a purchase price of \$7.14 per share. Various officers, directors, partners and members of Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund are members of the Company's board of directors. On February 22, 2006, Mr. Carr exercised options to purchase 1,750,000 shares of our common stock from Greenhill Capital Partners and LLR Equity Partners. As a result of this transaction, a tax deduction of \$26.4 million accrued to the Company and generated a current tax asset of \$10.7 million and a credit to Additional Paid In Capital of \$10.7 million during the nine months ended September 30, 2006.

On March 28, 2005, Carr Holdings, L.L.C., an entity controlled and managed by Robert O. Carr, the Company's Chief Executive Officer and Chairman, and his wife, sold 40,000 shares of our common stock to Thomas M. Sheridan, the Company's Chief Portfolio Officer, at a price of \$9.28 per share. In addition, Carr Holdings, L.L.C. granted Mr. Sheridan an option to purchase an additional 40,000 shares of common stock at any time prior to the earlier of (i) March 31, 2006, if the Company had not consummated its initial public offering or (ii) six months and 15 days after the consummation of the Company's initial public offering. On August 8, 2005, Mr. Sheridan exercised options to purchase 12,000 shares of the Company's common stock from Carr Holdings, L.L.C. On February 22, 2006, the remaining options to purchase 28,000 shares of the Company's common stock from Carr Holdings, L.L.C. were cancelled by mutual agreement between Mr. Sheridan and Carr Holdings, L.L.C. As consideration for the cancellation, Mr. Sheridan received a payment of \$361,900 from Carr Holdings L.L.C. The amount of the consideration was determined by subtracting the \$9.28 exercise price of the options from the closing price of the Company's common stock on the New York Stock Exchange on the day before the date of this cancellation agreement, or \$22.20, and multiplying the difference by 28,000 shares.

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13. Segments

The determination of the Company's business segments is based on how the Company monitors and manages the performance of its operations. The Company's operating segments are strategic business units that offer different products and services. They are managed separately because each business requires different marketing strategies, personnel skill sets and technology.

The Company has two reportable segments, as follows: (1) Card, which provides payment processing and related services related to bank card transactions; and (2) Other. The Other segment includes Payroll, which provides payroll and related tax filing services, and PrepaidCard, which provides prepaid card and stored-value card solutions. Neither the Payroll operating segment nor the PrepaidCard operating segment meet the SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information* defined thresholds for determining individually reportable segments. The PrepaidCard operating segment was acquired in the 2006 acquisition of Debitek, Inc.

The Company allocates revenues, expenses, assets and liabilities to segments only where directly attributable. The unallocated corporate administration amounts are costs attributed to finance, corporate administration, human resources and corporate services. Reconciling items represent elimination of inter-segment income and expense items, and are included to reconcile segment data to the consolidated financial statements. At September 30, 2006 and 2005, 63% and 87% respectively, of the Other segment's total assets were funds that the Company holds as a fiduciary in its Payroll services activities for payment to taxing authorities. The Company only operates in the United States and does not have any major individual customers.

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A summary of the Company's segments for the three and nine month periods ended September 30, 2006 and 2005 were as follows:

	Card Segment	Other Segments	Unallocated Corporate Administration Amounts (In thousands)	Reconciling Items	Total Amount
Three Months Ended September 30, 2006					
Total revenues	\$ 290,835	\$ 2,990	\$	\$ (35)	\$ 293,790
Depreciation and amortization	1,752	86	135		1,973
Interest income	292	139			431
Interest expense	264				264
Net income (loss)	13,287	108	(3,256)		10,139
Total assets	221,261	20,082		(7,352)	233,991
Three Months Ended September 30, 2005					
Total revenues	227,080	1,039		(27)	228,092
Depreciation and amortization	1,336	29	86		1,451
Interest income	178	61			239
Interest expense	418				418
Net income (loss)	8,881	141	(2,486)		6,536
Total assets	182,307	10,329		(2,167)	190,469
	Card Segment	Other Segments	Unallocated Corporate Administration Amounts (In thousands)	Reconciling Items	Total Amount
Nine Months Ended September 30, 2006					
Total revenues	\$ 799,786	\$ 8,968	\$	\$ (109)	\$ 808,645
Depreciation and amortization	4,888	263	385		5,536
Interest income	859	402			1,261
Interest expense	582	26			608
Net income (loss)	31,076	418	(9,522)		21,972
Total assets	221,261	20,082		(7,352)	233,991
Nine Months Ended September 30, 2005					
Total revenues	604,455	3,270		(77)	607,648
Depreciation and amortization	3,758	86	217		4,061
Interest income	245	177			422
Interest expense	1,391				1,391
Net income (loss)	19,488	752	(6,629)		13,611
Total assets	182,307	10,329		(2,167)	190,469

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Heartland Payment Systems, Inc. and Subsidiaries
Notes To Condensed Consolidated Financial Statements
September 30, 2006
(unaudited)

14. Earnings Per Share

The Company presents earnings per share data in accordance with SFAS No. 128, Earnings Per Share, as amended, (SFAS 128), which establishes the standards for the computation and presentation of basic and diluted earnings per share data. Under SFAS 128, the dilutive effect of stock options is excluded from the calculation of basic earnings per share but included in diluted earnings per share.

Weighted average shares outstanding and dilutive securities for the nine months ended September 30, 2005 have been adjusted to reflect a two-for-one stock split on July 26, 2005. The following is a reconciliation of the amounts used to calculate basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
(in thousands)				
Basic:				
Weighted average common stock outstanding	36,939	24,995	36,096	19,331
Earnings per share	\$ 0.27	\$ 0.21	\$ 0.61	\$ 0.46
Diluted:				
Net income attributable to common shares	\$ 10,139	\$ 5,210	\$ 21,972	\$ 8,883
Plus: income allocated to Series A Senior Convertible Participating Preferred Stock		1,326		4,728
Net income	\$ 10,139	\$ 6,536	\$ 21,972	\$ 13,611
Basic weighted average common stock outstanding	36,939	24,995	36,096	19,331
Effect of dilutive instruments:				
Stock options	3,016	5,781	3,825	4,666
Warrants		86		141
Series A Senior Convertible Participating Preferred Stock		7,785		12,726
Diluted weighted average shares outstanding	39,955	38,647	39,921	36,864
Earnings per share	\$ 0.25	\$ 0.17	\$ 0.55	\$ 0.37

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PART I FINANCIAL INFORMATION (continued)

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the accompanying notes to consolidated financial statements included elsewhere in this report, and the consolidated financial statements, notes to consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and the risk factors contained in our annual report on Form 10-K for the year ended December 31, 2005.

Forward Looking Statements

Some of the information in this Quarterly Report on Form 10-Q may contain forward-looking statements that are based on our management's beliefs and assumptions and on information currently available to our management. Forward-looking statements include the information concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, industry environment, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts and can be identified by the use of forward-looking terminology such as the words believe, expect, anticipate, plan, estimate or similar expressions.

Forward-looking statements involve risks, uncertainties and assumptions. Actual results may differ materially from those expressed in the forward-looking statements. You should understand that many important factors, in addition to those discussed elsewhere in this report, could cause our results to differ materially from those expressed in the forward-looking statements. These factors include, without limitation, our competitive environment, the business cycles and credit risks of our merchants, chargeback liability, merchant attrition, problems with our bank sponsor, our reliance on other bank card payment processors, our inability to pass increased interchange fees along to our merchants, the unauthorized disclosure of merchant data, economic conditions, system failures and government regulation.

Overview

General

Our primary business is providing bank card-based payment processing services to merchants in the United States. As of September 30, 2006, we provided our bank card processing services to approximately 129,100 active card merchants located across the United States. This represents a 21.2% increase over the 106,500 active merchants at September 30, 2005. Our processing volume for the three months ended September 30, 2006 was \$11.7 billion, a 26.4% increase from the \$9.3 billion processed during the same period in 2005. For the nine months ended September 30, 2006, our processing volume was \$31.9 billion, a 29.5% increase over the \$24.6 billion processed for the nine months ended September 30, 2005.

We have developed a number of proprietary Internet-based systems to increase our operating efficiencies and distribute our processing and merchant data to our three main constituencies: our sales force, our merchant base and our customer service staff. In 2001, we began providing authorization and data capture services to our merchants through our own front-end processing system, which we call HPS Exchange. In 2005, we began providing clearing, settlement and merchant accounting services through our own internally developed back-end processing system, which we call Passport. Passport enables us to customize these services to the needs of our Relationship Managers and merchants.

During the three months ended September 30, 2006 and 2005, we processed approximately 66% and 55%, respectively, of our transactions through HPS Exchange, which has decreased our operating costs per transaction. We substantially completed converting our merchants to Passport during the second quarter of 2006, which also is expected to decrease our operating costs per transaction. At September 30, 2006,

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approximately 123,300 of our active bank card merchants were processing on Passport, compared to 22,000 at December 31, 2005. With our conversion to Passport, our internally developed systems are providing substantially all aspects of most of our merchants' processing needs. Previously, we relied on third party vendors for many of these services including bank card authorization and data capture services, settlement and merchant accounting services. We will continue to process a minority of our transactions through third party front-end systems.

Our revenue is recurring in nature, as we typically enter into three-year service contracts that, in order to qualify for the agreed-upon pricing, require the merchant to achieve processing volume minimums. Most of our revenue is payment processing fees, which are a combination of a fee equal to a percentage of the dollar amount of each Visa or MasterCard transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to card-issuing banks through Visa and MasterCard and dues and assessment fees to Visa and MasterCard. Our business volume, and consequently gross processing revenue, is largely driven by the cumulative growth in the number of card processing merchants with whom we have processing contracts. This in turn is the result of the number of merchants that we install during a period, offset by the number of merchants who cease processing with us during that period. We also generally benefit from consumers increasing use of bank cards in place of cash and checks.

Significant increases in our sales force have led to significant growth in the number of merchants with whom we have processing contracts. Our sales force grew from 970 at September 30, 2005, to 1,230 at September 30, 2006. The number of new merchants installed during the three months ended September 30, 2006 grew by 12.7% to 12,864 new merchants installed for bank card and payroll processing, compared to 11,419 new merchants installed during the three months ended September 30, 2005. In order to continue to increase our gross processing revenue, we intend to increase both the size and productivity of our sales force. As a result of our commission-only compensation system for our sales force, we are able to increase the size of our sales force with minimal upfront costs. However, since we pay signing bonuses and commissions approximating 92% of the gross margin generated by a merchant in its first year, growth in merchant accounts consumes significant capital, as it typically takes approximately one year's processing to cover the outlays for signing bonuses, commissions and payroll taxes.

Same store sales, which represent the change in processing volume for all current merchants that were processing with us in the same month a year earlier, grew 3.5% on average during the three months ended September 30, 2006, compared with growth rates of 4.8% during the second quarter of 2006, 7.1% during the first quarter of 2006 and 7.5% during 2005. Same store sales growth results from the combination of the increasing use by consumers of bank cards for the purchase of goods and services at the point of sale, and sales growth experienced by our retained merchants. We attribute the second and third quarter of 2006 declines from the same store sales growth percentages that we experienced during the first quarter of 2006 and all of 2005 to a slowdown in the growth rate of retail sales, which was likely a result of the impact of rising energy costs and interest rates on the economy.

At September 30, 2006 we processed payroll for 3,874 customers, an increase of 50.3% from 2,578 payroll customers at September 30, 2005. Our total merchants, card plus payroll, increased to 132,974 at September 30, 2006. This represents a 21.9% increase over the 109,078 total merchants at September 30, 2005.

Third Quarter of 2006 Financial Results

For the three months ended September 30, 2006, we recorded net income of \$10.1 million, or \$0.25 per diluted share, an increase of 55.1% from \$6.5 million, or \$0.17 per diluted share, in the three months ended September 30, 2005. The increase was primarily driven by strong growth in our transaction processing volume, which led to a 32.0% increase in our net revenue and a 46.9% increase in our operating income, and by a reduction in our estimated effective annual tax rate. Net income for the three months ended September 30, 2005 included the impacts of a \$5.1 million pre-tax gain on the settlement of a financing arrangement, partially offset by a \$2.6 million pre-tax charge to adjust the fair value of previously outstanding warrants with mandatory redemption provisions. The following is a summary of our financial results for the three months ended September 30, 2006:

At September 30, 2006 the number of active total merchants we service increased to 132,974, compared to 113,164 at December 31, 2005 and 109,078 at September 30, 2005.

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Bank card processing volume during the three months ended September 30, 2006 increased 26.4% to \$11.7 billion from \$9.3 billion during the three months ended September 30, 2005.

Net revenue, which is defined as total revenues less interchange fees and dues and assessments, increased 32.0% to \$67.2 million during the three months ended September 30, 2006 from \$50.9 million during the three months ended September 30, 2005. The increase in net revenue was driven by the increases in active card merchants and processing volume, as well as payroll customers, and to a lesser extent, the acquisition of Debittek, Inc.

Our income from operations, which we also refer to as operating income, grew 46.9% to \$14.2 million for the three months ended September 30, 2006 from \$9.7 million for the three months ended September 30, 2005. Our operating margin, which is measured as operating income divided by net revenue, was 21.2% for the three months ended September 30, 2006, compared to 19.0% for the three months ended September 30, 2005.

In connection with preparing our 2005 state income tax returns, we analyzed the approaches we applied for sourcing taxable income to individual states and determined that our prior approaches did not accurately reflect the income sourcing regulations of certain of those states. We revised those state income sourcing approaches in the third quarter of 2006, and as a result, we realized reductions of our 2005 state income tax expense and our 2006 estimated effective annual state tax rates. We recorded the resulting total state tax benefit of \$1.5 million in the third quarter of 2006, of which \$0.5 million related to 2005 and \$1.0 million related to the nine months ended September 30, 2006, including \$0.4 million for the third quarter of 2006. Including the \$1.5 million of state tax benefits, our overall estimated effective annual tax rates for the three months ended September 30, 2006 and the nine months ended September 30, 2006 were 29.6% and 35.7%, respectively. For our 2006 fourth quarter and full year, we expect our overall estimated effective annual tax rates to be approximately 37.2% and 36.2%, respectively.

Components of Revenue and Expenses

Revenue. Our revenues fall into three categories: gross processing revenue, payroll processing revenue and equipment-related income. Our gross processing revenue primarily consists of discount, per-transaction and periodic (primarily monthly) fees from the processing of bank card transactions, primarily Visa and MasterCard transactions, for merchants. These fees are negotiated by our Relationship Managers with each merchant. Gross processing revenue also includes American Express and Discover fees, customer service fees, fees for processing chargebacks, termination fees on terminated contracts, and other miscellaneous revenue. Payroll processing revenue includes fees charged by our subsidiary, Heartland Payroll Company, for payroll processing services, including check printing, direct deposit, related federal, state and local tax deposits and providing accounting documentation. Equipment-related income includes revenues from the sale, rental and deployment of bank card terminals, and since January 1, 2006, from the sale of hardware, software and associated services for prepaid card and stored-value card payment systems. Revenues are recorded at the time of shipment, or the provision of service. Most of these revenue items will tend to grow with our merchant growth.

Expenses. Our most significant expense is interchange fees, which are set by the Visa and MasterCard card associations, and are paid to the card issuing banks. Interchange fees are calculated as a percentage of the dollar volume processed plus a per transaction fee. We also pay Visa and MasterCard association dues and assessments, which are calculated as a percentage of the dollar volume processed. Interchange fees and dues and assessments are recognized at the time transactions are processed. It is our policy to pass along to our merchants any changes in interchange fees and card association dues and assessments. Since the card associations regularly adjust those rates, our gross processing revenue will increase or decrease, but all the impact will be paid to the card issuing banks and our income from operations will not be affected.

Costs of services also include processing and servicing costs, customer acquisition costs, and depreciation and amortization. Processing and servicing costs include:

processing costs, which are either paid to third parties, including our bank sponsor, or represent the cost of our own authorization/capture and accounting/settlement systems. During the nine

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months ended September 30, 2006, third party costs represented about 73% of our processing costs, with internal costs representing the remainder. During 2005, third party costs represented about 75% of our processing costs, compared to 77% during 2004. Approximately 62%, 76% and 72%, respectively, of our third-party processing costs for the nine months ended September 30, 2006, and for 2005 and 2004 were paid to TSYS Acquiring Solutions (formerly Vital Processing Services);

residual commission payments to our Relationship Managers, sales managers and trade associations, agent banks and value-added resellers, which are a percentage of the gross margin we generated from our merchant contracts during the accounting period;

the costs of operating our service center, including telecommunications costs, personnel costs, occupancy costs, losses due to merchant defaults, and other direct merchant servicing expenses; and

the costs of bankcard terminals, prepaid card and stored value hardware deployed.

Customer acquisition costs reflect the amortization over the initial three-year contract term of the cash signing bonus paid and the deferred acquisition costs for vested Relationship Managers and sales managers, as well as changes in the accrued buyout liability, which reflect the impact of buying out residual commissions (see Critical Accounting Estimates Accrued Buyout Liability) and volume attrition.

Depreciation and amortization expenses are primarily recognized on a straight-line basis over the estimated useful life of the asset. We have made significant capital expenditures for computer hardware and software and such costs are generally depreciated over three to five years.

General and administrative expenses include salaries and wages and other administrative expenses. The two most significant elements in these expenses are our information technology infrastructure costs and our marketing expenses. Beginning January 1, 2006, general and administrative expenses also include expenses recorded for share-based compensation under SFAS No. 123R.

Other income (expense) consists of interest income on cash and investments, including interest income we earn on escrow funds held for payroll customers, the interest cost on our borrowings, the gains or losses on the disposal of property, plant and equipment and other non-recurring income or expense items. Other income (expense) also includes a gain from the proceeds received from a legal settlement in the nine months ended September 30, 2006, and during the nine months ended September 30, 2005, a gain on the settlement of a financing arrangement and adjustments to the fair value of previously outstanding warrants with mandatory redemption provisions.

Critical Accounting Estimates

The discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. These condensed consolidated financial statements are unaudited. In our opinion, the unaudited interim condensed consolidated financial statements include all normal recurring adjustments necessary for a fair presentation of our financial position at September 30, 2006, our results of operations, our changes in stockholders' equity and our cash flows for the three and nine months ended September 30, 2006 and 2005. Results of operations reported for interim periods are not necessarily indicative of the results to be expected for the year ended December 31, 2006. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results could differ from those estimates. Our significant accounting policies are more fully described in note 2 to our condensed consolidated financial statements included elsewhere in this report and in our annual report on Form 10-K for the year ended December 31, 2005. The critical accounting estimates described here are those that are most important to the depiction of our financial condition and results of operations, including those whose application requires management's most subjective judgment in making estimates about the effect of matters that are inherently uncertain. The line items on our income statement and balance sheet which are impacted by management's estimates are described below.

Table of Contents**Revenue**

Historically, we have paid 70% to 75% of our gross processing revenue as interchange fees to the card issuing banks. Certain of our competitors report their revenue net of interchange fees. This is because the issuing banks make their payments to these competitors net of those interchange fees, and these acquirers pay this reduced amount to their merchants. We do not offset gross processing revenue and interchange fees because our business practice is to fund the interchange fee or to arrange for our sponsor bank to advance the interchange fees to most of our merchants when settling their transactions (thus paying the full amount of the transaction to the merchant), and then to collect our full discount fees from our merchants on the first business day of the next month. We believe this policy aids in new business generation, as our merchants benefit from bookkeeping simplicity. However, it results in our carrying a large receivable from our merchants at each period-end, and a corresponding but smaller payable to our sponsor bank, both of which are settled on the first business day after the period-end. As we are at risk for the receivables, we record the associated revenues on a gross processing revenue basis in our income statements.

Capitalized Customer Acquisition Costs

Capitalized customer acquisition costs consist of (1) up-front signing bonuses paid to Relationship Managers and sales managers, referred to as the salesperson or salespersons, for the establishment of new merchant relationships, and (2) deferred acquisition costs representing the estimated cost of buying out the commissions of vested salespersons at some point in the future. Pursuant to Staff Accounting Bulletin Topic 13, *Revenue Recognition*, and the Financial Accounting Standards Board (FASB) Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The amount of the up-front signing bonus paid is based on the estimated gross margin (calculated by deducting interchange fees, dues and assessments and all costs incurred in underwriting, processing and servicing an account from gross processing revenue) for the first year of the merchant contract. The gross signing bonuses paid during the nine months ended September 30, 2006 and the year ended December 31, 2005 were \$23.1 million and \$24.4 million, respectively. The signing bonus paid, amount capitalized, and related amortization are adjusted at the end of the first year to reflect the actual gross margin generated by the merchant contract during that year. The net signing bonus adjustments made during the nine months ended September 30, 2006 and the year ended December 31, 2005 were \$0.8 million and \$(2.6) million, respectively. Negative signing bonus adjustments, such as the \$(2.6) million for the year ended December 31, 2005, result from the prior overpayment of signing bonuses and are recovered from the relevant salesperson. The amount of signing bonuses paid which remained subject to adjustment at September 30, 2006 and December 31, 2005 was \$30.1 million and \$24.4 million, respectively. The deferred acquisition cost is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability, which is described below.

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations. We have not recognized an impairment loss during the nine months ended September 30, 2006 and the year ended December 31, 2005.

Accrued Buyout Liability

We pay our salespersons residual commissions based on the gross margin generated from the monthly processing activity of merchants signed by them. A portion, typically 25% of the residual commissions we owe to the salesperson, is deemed to be a servicing fee and is not accrued as a liability. For the remainder of their residual commissions (referred to as the owned portion of such commissions, or portfolio equity) the salesperson has no obligation to perform services and will receive commissions as long as the merchant continues processing with us. We accrue the buyout liability, which represents the

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estimated current settlement cost of buying out all vested and expected-to-vest salespersons for the owned portion of such commissions. We also record a deferred acquisition cost asset related to those buyouts, and amortize that asset as an expense over the initial 3-year contract term.

We consider a salesperson to be vested once they have established merchant relationships that generate the equivalent of \$10,000 of monthly gross margin. Vested status entitles the salesperson to his or her residual commissions for as long as the merchant processes with us, even if the salesperson is no longer employed by us.

The accrued buyout liability is based on the merchants we have under contract at the balance sheet date, the gross margin we generated from those accounts in the prior twelve months, the owned commission rate, and the fixed buyout multiple of 2.5 times the commissions. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date.

For unvested salespersons, the accrued buyout liability is accrued over the expected vesting period; however, no deferred acquisition cost is capitalized as future services are required in order to vest. In calculating the accrued buyout liability for unvested salespersons, we have assumed that 31% of unvested salespersons will vest in the future, which represents our historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested salespersons by \$0.2 million at both September 30, 2006 and December 31, 2005.

Buyout payments made to salespersons reduce the outstanding accrued buyout liability. We believe that the benefits of such buyouts significantly exceed the cost, which typically represents 2 to 2 1/2 years of commissions, as we believe that the duration of the cash flows associated with a pool of merchant contracts exceeds that buyout cost by a significant margin. If the cash flows associated with a pool of bought out contracts does not exceed this cost, we will incur an economic loss on our decision to buyout the contracts. During the nine months ended September 30, 2006 and the 2005 full year, we made buyout payments of approximately \$8.0 million and \$13.5 million, respectively. Included in the \$13.5 million of buyout payments in 2005 was \$3.8 million used by salespersons who participated in the PEPShares Plan to exercise their options to acquire 677,544 shares of our common stock. We expect to make significant buyout payments in the future, subject to cash availability, as such buyouts reduce the monthly payments we will have to make to our salespersons for such merchants in the future.

Chargebacks, Reject Losses and Merchant Deposits

Disputes between a cardholder and a merchant periodically arise as a result of, among other things, the cardholder's dissatisfaction with merchandise quality or merchant services. Such disputes may not be resolved in the merchant's favor. In these cases, the transaction is charged back to the merchant, which means the purchase price is refunded to the customer by the card-issuing bank and charged to the merchant. If the merchant is unable to fund the refund, we must do so. If the Relationship Manager who installed the merchant is still employed by us, that Relationship Manager bears a portion of this loss through a reduction in our payment of residual commissions or signing bonuses to such Relationship Manager. We also bear the risk of reject losses arising from the fact that we collect our fees from our merchants on the first day after the monthly billing period. If the merchant has gone out of business during such period, we may be unable to collect such fees. We maintain cash deposits or require the pledge of a letter of credit from certain merchants, generally those with higher average transaction size where the card is not present when the charge is made or the product or service is delivered after the charge is made, in order to offset potential contingent liabilities such as chargebacks and reject losses that would arise if the merchant went out of business. At September 30, 2006 and December 31, 2005, we held merchant deposits totaling \$4.0 million, and \$7.0 million, respectively. Most chargeback and reject losses are charged to processing and servicing as they are incurred. However, we also maintain a loss reserve against losses including major fraud losses, which are both less predictable and involve larger amounts. The loss reserve was established using historical loss rates, applied to recent processing volume. Our loss reserve totaled \$480,000 at September 30, 2006 and \$485,000 at December 31, 2005. Aggregate merchant losses, including losses charged to operations and the loss reserve, were \$1,046,000 and \$1,206,000 for the nine months ended September 30, 2006 and the year ended December 31, 2005, respectively.

Table of Contents**Stock Options**

We adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123R) on January 1, 2006. This statement revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and its related implementation guidance. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under the fair value method. Pursuant to SFAS No. 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the requisite service period. We elected to adopt the modified-prospective-transition method, as provided by SFAS No. 123R. Accordingly, prior period amounts have not been restated. Under this transitional method, the Company is required to record compensation expense for all awards granted after the date of adoption using grant-date fair value estimated in accordance with the provisions of SFAS No. 123R and for the unvested portion of previously granted awards using the grant-date fair value estimated in accordance with the provisions of SFAS No. 123.

We estimate the grant date fair value of the stock options we issue using a Black-Scholes valuation model. We determine an expected volatility assumption by referencing the average volatility assumed by six of our public company peers. We used an average of a peer group because we do not have sufficient historical volatility data related to market trading of our own common stock. The weighted-average fair value of options we granted during the nine months ended September 30, 2006 and the years ended December 31, 2005 and 2004 were \$10.81, \$5.48 and \$2.74, respectively. The fair value of options granted for the nine months ended September 30, 2006 and the years ended December 31, 2005 and 2004 was estimated at the grant date using the following weighted average assumptions:

	Nine Months Ended	Years Ended December 31,	
	September 30, 2006	2005	2004
Expected volatility	50%	50%	50%
Expected life	3.75 years	3 years	1 to 3 years
Dividends	0.40%	0.00%	0.00%
Risk-free interest rate	4.88%	3.73%	2.31%

Prior to adopting SFAS No. 123R, we accounted for stock options using the intrinsic value method under APB No. 25 in which no compensation expense has been recognized for share-based compensation plans. Amounts we recognized in our financial statements during the three and nine months ended September 30, 2006 and 2005 with respect to share-based compensation plans were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Compensation expense recognized on share-based plans before income tax benefit	\$ 303	\$	\$ 764	\$
Related income tax benefit recognized in the income statement	74		151	
Cash received from stock option exercises	5,119	6,322	25,723	6,430
Excess tax benefit recorded for tax deductions resulting from the exercise of stock options	2,547		27,661	
Tax benefit realized as reductions of estimated tax payments during the period	3,850		8,050	

Additionally, SFAS No. 123R amends SFAS No. 95, *Statement of Cash Flows* (SFAS No. 95), to require the excess tax benefits to be reported as a financing cash inflow rather than a reduction of taxes paid, which is included within operating cash flows. Accordingly, cash provided by operating activities decreased and cash provided by financing activities increased by \$27.7 million related to excess tax benefits from share-based awards. We realized \$8.1 million of that amount as reductions of estimated income tax payments during the nine months ended September 30, 2006. The excess tax benefits result from employees exercising non-qualified stock options and making disqualifying dispositions of shares acquired through their exercise of incentive stock options.

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The application of SFAS No. 123R had the following effects on reported amounts relative to amounts that we would have reported using the intrinsic value method under APB No. 25 for the three and nine months ended September 30, 2006 (in thousands, except per share data):

	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
	Following APB No. 25	After Effect of Adopting SFAS No. 123R	Following APB No. 25	After Effect of Adopting SFAS No. 123R
Income from operations	\$ 14,548	\$ 14,245	\$ 33,434	\$ 32,670
Income before income taxes	14,715	14,412	34,918	34,154
Net income	10,368	10,139	22,585	21,972
Earnings per common share:				
Basic	\$ 0.28	\$ 0.27	\$ 0.63	\$ 0.61
Diluted	\$ 0.26	\$ 0.25	\$ 0.57	\$ 0.55
Net cash provided by (used in) operating activities	\$ 1,978	\$ 3,369	\$ 10,725	\$ (8,886)
Net cash provided by financing activities	3,691	2,300	8,209	27,820

The following table presents the effects on net income and basic and diluted net income per common share had the Company adopted the fair value method of accounting for share-based compensation under SFAS No. 123 for the three and nine months ended September 30, 2005 (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 30, 2005		September 30, 2005	
Net income	\$	6,536	\$	13,611
Deduct: Total share-based employee compensation expense determined under fair value-based method, net of related tax expense		1,848		3,767
Pro forma net income		4,688		9,844
Less: Income allocated to Series A Senior Convertible Participating Preferred Stock		951		3,430
Pro forma net income attributable to common stock	\$	3,737	\$	6,414
Earnings per share:				
As reported:				
Basic	\$	0.21	\$	0.46
Diluted	\$	0.17	\$	0.37
Pro forma:				
Basic	\$	0.15	\$	0.33
Diluted	\$	0.12	\$	0.27

Income Taxes

We account for income taxes pursuant to the provisions of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Under this method, deferred tax assets and liabilities are recorded to reflect the future tax consequences attributable to the effects of differences between the carrying amounts of existing assets and liabilities for financial reporting and for income tax purposes. Judgments are required in determining the amount and probability of future taxable income, which in turn is critical to a determination of whether a valuation reserve against the deferred tax asset or liability is appropriate.

Table of Contents**Results of Operations****Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005**

The following table shows certain income statement data as a percentage of revenue for the periods indicated (in thousands of dollars):

	Three Months Ended		Three Months Ended		Change	
	September 30, 2006	% of Total Revenue	September 30, 2005	% of Total Revenue	Amount	%
Total Revenues	\$ 293,790	100.0%	\$ 228,092	100.0%	\$ 65,698	28.8%
Costs of Services:						
Interchange	215,656	73.4%	168,550	73.9%	47,106	27.9%
Dues and assessments	10,920	3.7%	8,624	3.8%	2,296	26.6%
Processing and servicing	30,894	10.5%	22,567	9.9%	8,327	36.9%
Customer acquisition costs	8,774	3.0%	7,037	3.1%	1,737	24.7%
Depreciation and amortization	1,602	0.5%	1,447	0.6%	155	10.7%
Total costs of services	267,846	91.2%	208,225	91.3%	59,621	28.6%
General and administrative	11,699	4.0%	10,169	4.5%	1,530	15.0%
Total expenses	279,545	95.2%	218,394	95.7%	61,151	28.0%
Income from operations	14,245	4.8%	9,698	4.3%	4,547	46.9%
Other income (expense):						
Interest income	431	0.1%	239	0.1%	192	80.3%
Interest expense	(264)	(0.1)%	(418)	(0.2)%	154	(36.8)%
Fair value adjustment for warrants with mandatory redemption provisions			(2,620)	(1.1)%	2,620	(100.0)%
Gain on settlement of financing arrangement			5,140	2.3%	(5,140)	(100.0)%
Other, net			4		(4)	(100.0)%
Total other income (expense)	167	0.1%	2,345	1.0%	(2,178)	(92.9)%
Income before income taxes	14,412	4.9%	12,043	5.3%	2,369	19.7%
Provision for income taxes	4,273	1.5%	5,507	2.4%	(1,234)	(22.4)%
Net income	\$ 10,139	3.5%	\$ 6,536	2.9%	\$ 3,603	55.1%

Revenue. Total revenues increased 28.8% from \$228.1 million for the three months ended September 30, 2005 to \$293.8 million for the three months ended September 30, 2006, primarily as a result of a 27.3% increase in our gross processing revenue on bank card transactions from \$226.0 million for the three months ended September 30, 2005 to \$287.8 million for the three months ended September 30, 2006. Our processing volume for the three months ended September 30, 2006 increased 26.4% to \$11.7 billion, compared to \$9.3 billion for the three months ended September 30, 2005. The increases in gross processing revenue and processing volume were primarily attributable to a net increase in merchant accounts, with the number of bank card merchant accounts growing by approximately 21.2% from 106,500 as of September 30, 2005 to 129,100 as of September 30, 2006. The increase in new merchant accounts during this period was primarily the result of the growth in our sales force, combined with improved production from our existing sales force. The sales force grew by 26.8% from 970 as of September 30, 2005 to 1,230 as of September 30, 2006.

Total revenues also include payroll processing fees and equipment-related income. Payroll processing fees increased by 37.2% from \$1.0 million for the three months ended September 30, 2005 to \$1.4 million in for the three months ended September 30, 2006 primarily due to the 50.3%

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increase in the number of payroll processing customers from 2,578 at September 30, 2005 to 3,874 at September 30, 2006.

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Equipment-related income increased by \$3.5 million, from \$1.0 million for the three months ended September 30, 2005 to \$4.5 million for the three months ended September 30, 2006 primarily due to the increase in the number of new card processing merchants installed and \$1.5 million of revenues contributed by Debitex, which we acquired as of January 1, 2006.

Costs of services. Costs of services increased 28.6% from \$208.2 million for the three months ended September 30, 2005 to \$267.8 million for the three months ended September 30, 2006, due primarily to an increase in interchange fees, which resulted from higher processing volume. Costs of services represented 91.2% and 91.3% of total revenue in the three months ended September 30, 2006 and September 30, 2005, respectively.

Interchange fees increased 27.9% from \$168.6 million for the three months ended September 30, 2005 to \$215.7 million for the three months ended September 30, 2006 and represented 73.4% and 73.9% of total revenue for the three months ended September 30, 2006 and 2005, respectively. Interchange expense for the three months ended September 30, 2006 increased primarily due to higher processing volume.

Dues and assessments increased 26.6% from \$8.6 million for the three months ended September 30, 2005 to \$10.9 million for the three months ended September 30, 2006, also due to the increased processing volume. As a percentage of total revenue, dues and assessments declined from 3.8% for the three months ended September 30, 2005 to 3.7% for the three months ended September 30, 2006.

Net revenue, which is defined as total revenues less interchange fees and dues and assessments, increased 32.0% from \$50.9 million for the three months ended September 30, 2005 to \$67.2 million for the three months ended September 30, 2006.

Processing and servicing expense for the three months ended September 30, 2006 increased by \$8.3 million, or 36.9%, compared with the three months ended September 30, 2005. The increase in the amount of processing and servicing expense was due primarily to (i) processing costs associated with increased processing volume, (ii) increases in the cost of bankcard terminals, prepaid card and stored value hardware deployed (including \$0.9 million for the costs of Debitex equipment deployed), (iii) a \$2.7 million increase in residual commission payments to our salespersons related to their portion of the growth in our gross margin, and (iv) increases in the costs of operating our service center, including the number of support personnel and depreciation and amortization. As a percentage of total revenue, processing and servicing expense increased from 9.9% for the three months ended September 30, 2005 to 10.5% for the three months ended September 30, 2006. However, this percentage is a decline from 11.9% during the three months ended March 31, 2006 and 10.6% during the three months ended June 30, 2006. The increase from the three months ended September 30, 2005 in processing and servicing as a percentage of total revenue was mitigated by leveraging the lower costs of our internally developed processing systems: HPS Exchange our front-end processing system, and to a lesser extent, Passport our back-end processing system. Transactions processed on HPS Exchange represented approximately 66% of our total processing transactions during the three months ended September 30, 2006 compared to 55% during the three months ended September 30, 2005. We expect the increasing share of HPS Exchange in our total merchant base to continue in the future. As of May 1, 2006, our conversion to Passport was substantially complete. We expect to fully realize the lower cost benefits of processing on Passport in future periods. Included in processing and servicing expense was \$0.7 million of payroll processing costs in the three months ended September 30, 2006, which increased 77.8% from \$0.4 million in the three months ended September 30, 2005.

Customer acquisition costs increased 24.7% from \$7.0 million for the three months ended September 30, 2005 to \$8.8 million for the three months ended September 30, 2006. The net amortization of signing bonuses increased from \$3.6 million for the three months ended September 30, 2005 to \$5.7 million for the three months ended September 30, 2006, while the amortization of capitalized customer deferred acquisition costs grew from \$2.7 million for the three months ended September 30, 2005 to \$3.2 million for the three months ended September 30, 2006. Increases in new merchant account installations and the related processing volume were primarily responsible for the increases in the amortization of both the capitalized customer deferred acquisition costs and signing bonuses.

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Depreciation and amortization expenses increased 10.7% from \$1.4 million for the three months ended September 30, 2005 to \$1.6 million for the three months ended September 30, 2006. The increase was primarily due to the purchase of information technology equipment to support the network and the development of HPS Exchange and Passport. Additionally, we capitalized salaries and fringe benefits and other expenses incurred by employees that worked on internally developed software projects. Amortization does not begin on the internally developed software until the project is complete and placed in service, at which time we begin to amortize the asset over three to five years. The amount capitalized increased from \$320,000 for the three months ended September 30, 2005 to \$559,000 for the three months ended September 30, 2006. The total amount of capitalized projects placed in service for the three months ended September 30, 2006 and 2005 was \$380,000 and \$2.0 million, respectively. Beginning January 1, 2006, depreciation and amortization expense associated with our service center was included in processing and servicing expense. For the three months ended September 30, 2006, service center-related depreciation and amortization expense was \$0.4 million.

General and administrative. General and administrative expenses increased 15.0% from \$10.2 million for the three months ended September 30, 2005 to \$11.7 million for the three months ended September 30, 2006. The increase was primarily due to added costs necessary to continue building our corporate, information technology and marketing infrastructure to support our growth.

Also contributing to the increase in general and administrative expenses for the three months ended September 30, 2006 was \$150,000 for matching payroll tax expense related to gains employees realized on the exercise of non-qualified stock options, \$591,000 of general and administrative expenses incurred by Debittek, and \$303,000 for SFAS No. 123R share-based compensation expense. General and administrative expenses as a percentage of total revenue declined from 4.5% for the three months ended September 30, 2005 to 4.0% for the three months ended September 30, 2006, as revenue growth outpaced the increase in expenses. Our payroll operation's general and administrative expenses increased by 40.8% from \$556,000 for the three months ended September 30, 2005 to \$783,000 for the three months ended September 30, 2006.

Income from operations. For the reasons described above, income from operations improved from \$9.7 million for the three months ended September 30, 2005 to \$14.2 million for the three months ended September 30, 2006. Our operating margin, which is measured as operating income divided by net revenue, was 21.2% for the three months ended September 30, 2006, compared to 19.0% for the three months ended September 30, 2005.

Interest income. Interest income increased from \$239,000 for the three months ended September 30, 2005 to \$431,000 for the three months ended September 30, 2006, due primarily to an increase in the amount of cash available for investment and higher interest rates.

Interest expense. Interest expense decreased from \$418,000 for the three months ended September 30, 2005 to \$264,000 for the three months ended September 30, 2006. Most of our interest expense arises from the practice of having our sponsor bank advance interchange fees to most of our merchants. In August 2005, we began using a portion of our available cash to fund these advances. These advances to our merchants are funded first with our cash available for investment, then by incurring a payable to our sponsor bank when that cash has been expended. We pay the sponsor bank the prime rate on these payables. The payable to the sponsor bank is repaid at the beginning of the following month out of the fees we collect from our merchants. Interest expense for the three months ended September 30, 2005 also included \$24,000 of interest expense recorded on a revolver advance facility and line of credit which we paid off in August 2005 using proceeds from our initial public offering.

Fair value adjustment for warrants with mandatory redemption provisions. We recognized expense of \$2.6 million during the three months ended September 30, 2005 to adjust the warrants' carrying value to \$26.51 per share, the closing price of our common stock on the day prior to the exercise of the warrants. The warrants were exercised on August 16, 2005.

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Gain on settlement of financing arrangement. On September 23, 2005, we reacquired the remaining 2,400 merchant contracts previously transferred to Certegy Inc. in a transaction accounted for as a financing arrangement for a cash payment of \$3.0 million, fully extinguishing our obligations under the financing arrangement. The outstanding balance of this financing arrangement at the time of extinguishment was \$8.1 million, resulting in a pre-tax gain on the settlement of a financing arrangement of \$5.1 million in the three months ended September 30, 2005.

Income Tax. Income taxes for the three months ended September 30, 2006 were \$4.3 million reflecting an effective tax rate of 29.6%. This represented a reduction from an effective tax rate of 45.7% for the three months ended September 30, 2005, which resulted in income tax expense of \$5.5 million. The reduction in the effective tax rate was due to revising state income sourcing approaches in the third quarter of 2006 and the impact of the fair value adjustment for warrants included in the three months ended September 30, 2005. As a result of revising state income sourcing approaches in the third quarter of 2006, we realized reductions of our 2005 state income tax expense and our 2006 estimated effective annual state tax rates. In accordance with APB 28, *Interim Financial Reporting*, we recorded the resulting total state tax benefit of \$1.5 million in the third quarter of 2006, of which \$0.5 million related to 2005 and \$1.0 million related to the nine months ended September 30, 2006, including \$0.4 million for the third quarter of 2006.

Net income. As a result of the above factors, net income increased from \$6.5 million for the three months ended September 30, 2005 to \$10.1 million for the three months ended September 30, 2006.

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The following table shows certain income statement data as a percentage of revenue for the periods indicated (in thousands of dollars):

	Nine Months Ended		Nine Months Ended		Change	
	September 30, 2006	% of Total Revenue	September 30, 2005	% of Total Revenue	Amount	%
Total Revenues	\$ 808,645	100.0%	\$ 607,648	100.0%	\$ 200,997	33.1%
Costs of Services:						
Interchange	592,426	73.3%	444,100	73.1%	148,326	33.4%
Dues and assessments	29,732	3.7%	22,938	3.8%	6,794	29.6%
Processing and servicing	88,656	11.0%	64,919	10.7%	23,737	36.6%
Customer acquisition costs	25,269	3.1%	20,278	3.3%	4,991	24.6%
Depreciation and amortization	4,403	0.5%	4,056	0.7%	347	8.6%
Total costs of services	740,486	91.6%	556,291	91.5%	184,195	33.1%
General and administrative	35,489	4.4%	28,448	4.7%	7,041	24.8%
Total expenses	775,975	96.0%	584,739	96.2%	191,236	32.7%
Income from operations	32,670	4.0%	22,909	3.8%	9,761	42.6%
Other income (expense):						
Interest income	1,261	0.2%	422	0.1%	839	198.8%
Interest expense	(608)	(0.1)%	(1,391)	(0.2)%	783	(56.3)%
Fair value adjustment for warrants with mandatory redemption provisions			(2,912)	(0.5)%	2,912	(100.0)%
Gain on settlement of financing arrangement			5,140	0.8%	(5,140)	(100.0)%
Other, net	831	0.1%	11		820	nm
Total other income (expense)	1,484	0.2%	1,270	0.2%	214	16.9%
Income before income taxes	34,154	4.2%	24,179	4.0%	9,975	41.3%
Provision for income taxes	12,182	1.5%	10,568	1.7%	1,614	15.3%
Net income	\$ 21,972	2.7%	\$ 13,611	2.2%	\$ 8,361	61.4%